The Basics of Investing PFL.6 (B)

It’s actually pretty simple: investing means putting your money to work for you. Essentially, it’s a different way to think about how to make money. Growing up, most of us were taught that you can earn an income only by getting a job and working. And that’s exactly what most of us do. There’s one big problem with this: if you want more money, you have to work more hours. However, there is a limit to how many hours a day we can work, not to mention the fact that having a bunch of money is no fun if we don’t have the leisure time to enjoy it.

You can’t create a duplicate of yourself to increase your working time; so instead, you need to send an extension of yourself – your money – to work. That way, while you are putting in hours for your employer, or even mowing your lawn, sleeping, reading the paper or socializing with friends, you can also be earning money elsewhere. Quite simply, making your money work for you maximizes your earning potential whether or not you receive a raise, decide to work overtime or look for a higher-paying job. But before you can start, you need to know the basics of investing.

**Part 1 – Develop a Personal Investment Strategy.**  
To do this you should have:   
**1. Knowledge of Financial Markets** – Financial markets have had many ups and downs over the past ten years.  From hot times to slower recessions markets will always continue to fluctuate, and with that comes good times and bad times for your money.  So you have a better idea of what financial markets have been like, complete this activity.

**2. Knowledge of  Your Financial Assets-** A **financial asset** is an intangible asset that creates value because of a contractual claim. Examples include bank deposits, bonds, and stocks. Financial assets are usually more liquid than tangible assets, such as land or real estate, and are traded on financial markets. Take a minute and list the different financial assets you think you have.

**3. Knowledge of Your Risk Tolerance-**Risk tolerance is an investing term relating to the amount of market risk, especially the volatility (ups and downs), an investor can tolerate. Usually gauged by a calculator or questionnaire, risk tolerance is often used to categorize investors as Aggressive, Moderate or Conservative.   
 Check your risk tolerance using the quizzes: <http://njaes.rutgers.edu:8080/money/riskquiz/> and <http://www.efgi.com/personal/investing/questionnaire.html>

**4. How Much You Plan to Invest** – What is it that you hope to put into an investment?  What are you most comfortable with investing?  What are your hopes for your monet?  These are all questions that need to be answered.

For steps 2, 3, and 4 I want you to write a reflection.  Answer all of the questions, tell me about your assets and what type of risk taker you are.

**Part 2 – Establishing Your Investment Objectives**

At this time you will be deciding on what it is that you need from your investment portfolio and in what timeframe you think you need it by.  In order for you to choose the right investment you need to understand how aggressive or what type of investor you would be.  By doing the following questionnaire, you will be able to determine the type of investor you are and how aggressive you should be.

**Part 3 – Understanding Your Tolerance for Risk**.

This includes factors such as:

-time horizons (time you have to meet your financial goals)

-cash requirements (extent to which you depend on investments to meet day-to-day expenses)

-emotional factors (emotional responses to risk and to changes in the value of your investments)

Looking at these factors, write a reflection that focuses on these.  Tell me to what extent you would rely on your investments to help you out day to day.  Would you be able to live without them, allowing a longer period for growth?  Would you prefer a shorter period for growth?  Why?

**Part 4 – Diversification and Asset Mix**

An asset mix is a  Percentage of an investment  portfolio that is invested in each of the three major classes of assets: (1) cash and equivalents,  (2) fixed  income instruments  (bonds, notes) and,  (3) equity  instruments (common  stock or ordinary  shares).

The right asset mix should:

* help balance risk with your expected rate of return on your investments,
* fit your tolerance for risk,
* let you to get your money when you need it,
* help provide the growth you need to reach your goals, and
* change as your needs and goals change over time.

**Why the right asset mix is important**

By holding a mix of investments from the 3 main asset classes:

* **Cash and cash equivalents** – like savings accounts, GICs and money market funds. This category is virtually risk-free but produces the lowest returns.
* **Fixed income investments** – like bonds and fixed income mutual funds. This category offers  
  higher returns and provides a regular source of investment income.
* **Equities** – like stocks, equity mutual funds and ETFs. This category contains high-risk assets which can grow in value if the holder can wait it out, but can also result in greater losses as      well.

Deciding how much of your portfolio to invest in each asset class is called asset allocation.

Your asset mix will largely determine the risk and expected return of your portfolio. To get the right mix for you, be sure that your asset mix matches your risk tolerance, financial goals and time horizon.

Diversification is a way to try to reduce risk by choosing a mix of investments. With a diversified portfolio, you spread your money across different types of investments (or asset classes)

Video: Good and Bad Portfolio Building Blocks <https://youtu.be/epcju0IF-qk>

**How diversification works**

Under normal market conditions, diversification is an effective way to balance risk and return. If you hold just 1 type of investment and it performs badly, you may lose everything. If you hold many types of investments, it’s much less likely that all of your investments will perform badly at the same time. The return you earn on the investments that perform well could offset some of the losses on those that perform poorly.

For example, fixed income investments and equities often move in opposite directions. When investors expect the economy to weaken and corporate profits to drop, stock prices will likely fall. When this happens, central banks may cut interest rates to reduce borrowing costs and stimulate spending. This causes bond prices to rise. If your portfolio includes both stocks and bonds, the increase in the value of bonds may help offset the decrease in the value of stocks.

**Diversifying within asset classes**

There are ways to diversify within asset classes, too. For example, try not to hold all of your stocks in just 1 industry sector, such as banks or technology. That’s because different sectors respond differently to changes in the economy, and some sectors are riskier than others.

Within your bond holdings, you may want to diversify by choosing bonds with different credit ratings and terms to maturity. The video below shows you how to diversify within different asset classes.

Video: Diversification <https://youtu.be/0CsolRj6HSg>

**4 reasons to diversify**

1. Not all types of investments perform well at the same time.
2. Different types of investments react differently to world events, interest rates and other factors in the economy.
3. When 1 type of investment is down, another may be up.
4. Having a mix of different types of investments may help smooth out your returns.

**Changing your asset mix over time**

As your financial goals and needs change, you will likely want to review – and possibly change – your asset mix. Here are a few examples.

* If you’ve just started your first job – You may not have a lot of savings and you may be paying off student debt. But you may also have more time to reach some of your financial goals. At this stage of life, you may be willing to take more risks with your long-term investments.
* If you’re more established in your career – You’ll likely be earning more. And your financial goals will likely have changed. You may be paying down a mortgage, and saving for a child’s education or for your retirement. At this point, you may be interested in a mix of higher- and lower-risk investments.
* As you approach retirement – You might want to start shifting into lower-risk investments. Protecting your savings may become more of a priority because you’ll need to live on your investments after you retire. You may also want to look into investments that create a steady, reliable stream of income.

**Part 4 – Do Your Research Before Investing**

In order to be a smart investor you must first do your homework.  For each investment there are three characteristics that should be identified.

1. Expected Return
2. Investment Risk
3. Marketability

**Expected Return**

An expected return is the amount one would anticipate receiving on an investment that has various known or expected rates of return. For example, if one invested in a stock that had a 50% chance of producing a 10% profit and a 50% chance of producing a 5% loss, the expected return would be 2.5% (0.5 \* 0.1 + 0.5 \* -0.05). It is important to note, however, that the expected return is usually based on historical data and is not guaranteed.

For the most part, the expected return is a tool used to determine whether or not an investment has a positive or negative average net outcome – it is not a hard and fast figure of profit or loss. In the example above, for instance, the 2.5% expected return cannot, in fact, be realized – it is merely an average.

In addition to expected return, wise investors should also consider the probability of return in order to properly assess risk. After all, one can find instances in which certain lotteries offer a positive expected return, despite the very low probability of realizing that return.

**Investment Risk**

The chance that an investment’s actual return will be different than expected. Risk includes the possibility of losing some or all of the original investment. Different versions of risk are usually measured by calculating the standard deviation of the historical returns or average returns of a specific investment. A high standard deviation indicates a high degree of risk.

Many companies now allocate large amounts of money and time in developing risk management strategies to help manage risks associated with their business and investment dealings. A key component of the risk mangement process is risk assessment, which involves the determination of the risks surrounding a business or investment.

A fundamental idea in finance is the relationship between risk and return. The greater the amount of risk that an investor is willing to take on, the greater the potential return. The reason for this is that investors need to be compensated for taking on additional risk.

For example, a Canada Savings bond is considered to be one of the safest (risk-free) investments and, when compared to a corporate bond, provides a lower rate of return. The reason for this is that a corporation is much more likely to go bankrupt than the government. Because the risk of investing in a corporate bond is higher, investors are offered a higher rate of return.

**Marketability**

Marketable investments are investments for which there exists a liquid, active market, i.e., the investments can be bought and sold easily and quickly without the risk of much price movement.

Securities with the highest degree of marketability are high quality, low risk securities such as those  
issued by governments.

As many such government issues are considered to be practically risk-free, their rate of return or discount is often used as a benchmark rate for establishing various other lending rates and instrument  
(e.g., derivative) prices.

Using the chart below you will do your investment homework.  You will find four different types of investments from each investment class and tell me what their expected rate of return is, their investment risk and whether or not their marketability is high.